IN THE

Supreme Court of the United States

No. 552

INTERSTATE TRANSIT LINES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITIONER'S BRIEF.

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To the Honorable Chief Justice and Associate Justices of the United States Supreme Court:

OPINIONS BELOW.

The opinion of the Board of Tax Appeals is reported at 44 B. T. A. 957. The opinion of the Circuit Court of Appeals is reported at 130 Fed. (2d) 136.

JURISDICTION.

This case is here upon a writ of certiorari which was granted March 8, 1943, to review the decision of the Circuit Court of Appeals for the Eighth Circuit, entered July 31, 1942, affirming the decision of the Board of Tax Appeals in an income tax case involving the taxable year 1936, in which the Board sustained a deficiency determined for that year by the respondent. The jurisdiction of this Court is sustained by Section 240 of the Judicial Code, as amended (U. S. Code, Title 28, Section 347) and by Section 1141 of the Internal Revenue Code (U. S. Code, Title 26, Section 1141). The Circuit Court of Appeals had jurisdiction under the second of these sections, namely, Section 1141.

STATEMENT OF THE CASE.

(Numerals in Parentheses refer to pages of the printed record.)

Respondent determined a deficiency of $4,461.53 in petitioner's 1936 income tax. The Board of Tax Appeals, in a decision rendered July 9, 1941 (19), upheld the Commissioner. The Circuit Court of Appeals for the Eighth Circuit affirmed the Board (78). 130 Fed. [2d] 136. Certiorari was granted March 8, 1943, to review that decision.

The deficiency is predicated upon the disallowance of a deduction claimed by taxpayer of $28,100.66, the amount by which 1936 expenses allocated to taxpayer's subsidiary, Union Pacific Stages of California (herein referred to as "Stages"), exceeded its allocated receipts. Petitioner, the taxpayer (herein sometimes referred to as "Interstate"), actually, and without any offsetting benefit or consideration other than Stages' nominal conduct of taxpayer's California business operations, bore the economic burden of this operating deficit, no part of which represented any advance for capital purposes (41). A formal contract,

between the two companies, entered into in 1932, required Interstate to assume this deficit. The Commissioner disallowed the deduction on the ground that "no provision of the Revenue Act of 1936 authorizes such deduction" (8). Taxpayer claims the right to the deduction under Section 23(a) of the Revenue Act of 1936, 48 St. L. 1658, as an "ordinary and necessary expense" of carrying on its business.

The facts are not in dispute. The taxpayer is a Nebraska corporation organized in 1929 and engaged in transcontinental bus transportation between Chicago and the Pacific Coast. The answer admits (13) that taxpayer during the year 1936 was engaged in the operation of motor buses for the transportation of passengers between Chicago and Los Angeles. After 1932 and throughout 1936 the portion of each bus trip between the California line and Los Angeles, although actually a part of Interstate's operation, was nominally operated by taxpayer's subsidiary, Stages, under the arrangement hereinafter described, which the petitioner claims created the relation of agency between the two companies. After this arrangement was made, intrastate passengers were also carried, which had not theretofore been the case. The Circuit Court of Appeals assumed, (130 Fed. [2d] 136, at p. 139, Rec. p. 75) that Stages was taxpayer's agent as to the interstate portion of the business. The intrastate business was but a fraction of the total business done in California. Revenues allocated to the California business, interstate and intrastate, amounted in 1936 to $183,365.60 (Respondent's Exhibit C, Rec. pp. 45, 66, 67). Expenses allocated to such business, all of which were actually paid by Interstate, amounted to $211,470.59 (*ibid*). This latter figure is what it cost, according to the allocation to the California operation, to carry on (through Stages' nominal agency) the

California portion of the interstate operation[1], in which respondent's pleading admits taxpayer was engaged. It cost no more to handle the few intrastate passengers whose fares, only about $10,000 in all (34), are reflected in the total revenue figure[2]; the Board found (16) that no additional expense was thereby incurred, except the cost of keeping separate accounts (represented by account books and ink and the time necessary to make the book entries, 42); and the Court below accepted "the theory that the expense of carrying intra-California traffic may be disregarded as insignificant" (75). The difference between these two figures of revenues and expenses, $183,-365.60 and $211,470.59, respectively, represents (except for a minor and immaterial adjustment) the item of $28,100.66 in controversy. This net deduction is claimed as an ordinary and necessary expense of carrying on petitioner's business.

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[1] The Board's opinion in this respect (18) is not supported by the evidence nor consistent with the Board's own findings (16). The Circuit Court of Appeals accepted the above statement as a fact (75).

[2] The findings are silent as to the treatment of intrastate revenues. Hall, the Auditor, testified that they were assigned direct to Stages. Haugh, the Vice President, who "never paid any attention * * * to the California company because those (expenses and revenues) were absorbed by this agreement by the earnings of the parent company" (36), testified (24) that the management "estimated at the time (of going into the California operation) that there would be about $10,000 added to the revenue by reason of intrastate business." He added that "although we have never kept the accounts separate as to revenue from the intrastate business and interstate business, it probably exceeds that amount and did in 1936." Haugh was evidently mistaken as to failure to segregate interstate and intrastate revenues.

The immediate occasion for using the subsidiary, Stages, was the attitude of the California Railroad Commission toward the conduct by a corporation foreign to that state of an intrastate passenger bus business. Although unable to prevent taxpayer from conducting interstate operations between California points and places outside of California, the Commission had a settled policy of refusing to issue to a foreign corporation a certificate of convenience and necessity to conduct intrastate bus operations. As to years prior to 1936 it is most doubtful whether the Commission correctly construed the California law.[1] By 1936 a California statute, passed in 1935, affirmatively provided that foreign corporations engaged in interstate commerce might transact within the state "such commerce and intrastate commerce of like character".[2] Whether or not the Commission was correct, its attitude appeared, in years prior to 1935, to make it impossible or at least difficult for Interstate itself to carry intrastate passengers in California, a right it had in other states. Being desirous to secure that traffic and add the revenue therefrom to its interstate revenue (34) and thus obtain additional passengers for vacant seats in its through buses without having to incur additional expenses (35), taxpayer for this purpose in 1930 organized Stages under the California laws. By 1932 Stages had, with the State Commission's approval, secured the franchise necessary for intrastate operation (15). Interstate furnished all Stages' capital[3] and recevied all its stock (*ibid*). (No part of this capital investment is in any way involved in the present proceeding.)

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[1] The relevant statutes are set out in the appendix, and are discussed, *infra*, p. 58.

[2] See Appendix, *infra*, p. 63.

[3] With which two buses were purchased, *infra*, p. 6, footnote.

Formal contracts, dated February 7, and 8, 1932 (respectively referred to as the "absorption" and "operating" agreements) were executed by parent and subsidiary. Neither contract was suggested by or involved any element of tax avoidance, or at the time had any tax significance, one way or the other, because the companies then filed consolidated returns. The "absorption" contract recited among other things that Stages was maintained as an operating subsidiary of taxpayer and that its operations were conducted solely for Interstate's benefit; that in order that the latter might obtain the greatest benefit it was necessary that Stages' schedules be coordinated with Interstate's and that Stages operate on such routes and upon such schedules as would most greatly benefit Interstate, and that such operation might not be so remunerative to Stages as operation solely for its own corporate benefit. It was therefore provided, among other things, that Interstate would "assume and reimburse the California corporation for any deficits incurred by the California corporation in its operations" (Petitioner's Exhibit 1, 34, 57).

The "operating" agreement provided, in substance, that buses of Interstate (which had theretofore operated its buses through to Los Angeles) should on each trip continue through, but at the State Line should pass into Stages' custody and that Stages' buses[1], traveling northward, were at the State line to pass into Interstate's custody. Each party leased its buses to the other, while thus in the other's custody, for five cents per bus mile while in such custody, the lessee in such instance to bear expenses (other than drivers' wages and taxes) and insur-

[1] Two buses were bought in 1932, nominally by Stages, with capital funds contributed by Interstate (31). These were "operated in a pool with the parent company's buses" (36).

ance properly attributable to the buses while in its possession. Drivers were to be the employes of and their wages paid by the lessee while in service in connection with leased buses, the effect of which was to make drivers the formal employes of Stages while in California and of Interstate when outside of California. (All drivers were actually paid by Interstate, *infra*, p. 8). Each party was to pay taxes on its own buses (Petitioner's Exhibit 2, 34, 58-60).

After this arrangement was made, the California local business (revenue from which, as already stated, was in 1936 only about $10,000) (34) was handled without additional expense in the same buses previously operated by Interstate (35). There were the same schedules and no physical changes whatever. The only change was in bookkeeping. There was no breach in the operation of buses or change of passengers at the State line. The expenses which produced the deficit represented the expense of conducting the interstate operation, as the Court below correctly assumed.

In harmony with the California Commission's interpretation of the local law, the local franchises from the Nevada-California State line westward were obtained in the name of Stages (33). Prior to the organization of Stages and the time when intrastate passengers were carried, Interstate had already secured a bus terminal in Los Angeles (35). After Stages was formed, the Los Angeles bus terminal, which was held under a lease, was transferred to Stages, and in 1936 the lease "stood in the name of the California Company" (35). There was also a lease covering a garage at Los Angeles that was taken out in the name of Interstate, which when Stages was formed was transferred to it (*ibid*). Bus depots in California and agencies for the sale of tickets had been opened by Inter-

state for the interstate business (*ibid*). After Stages was organized, the same agencies that had sold Interstate tickets became also the agencies for intrastate tickets (*ibid*). This is the extent of Stages' relations with third persons disclosed by the record. Even the dealing as to these relations was with Interstate only.[1]

Interstate and Stages had the same officers and directors (16). Stages' accounting records, though kept separately, were kept at taxpayer's office and by taxpayer's officers and employees (*ibid*). Stages never had any bank account (*ibid*). Its revenue and expenses were handled by taxpayer (*ibid*), which was Stages' banker (55). It had no pay-roll (40). Employes below the classification of general officers, whose salaries were apportioned on the books (*ibid*), who participated in the conduct of the California business, were carried only on Interstate's payrolls and paid by Interstate vouchers, without segregation for services performed in California (*ibid*). Interstate collected all Stages' revenue and paid all bills, payrolls and otherwise (16, 40, 41).

While in a very limited sense it is literally true, as recited in the findings (16), that Stages had its own accounting records, employes, buses, directors and corporate minute book, yet all employes of both companies were carried on Interstate payrolls and for all services performed,

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[1] Answers of the witness Haugh, Interstate's Vice President, to leading questions on cross-examination were to the effect that Stages was "doing business," "selling tickets," and "had buses running on the roads" (38). These answers, by way of conclusion, which were put by counsel into the mouth of the witness, do not change the objective fact that Stages had no bank account, that Interstate collected all revenues and paid all expenses, and that the extent of Stages' relations with third persons was that stated in the text above.

whether nominally for Interstate or Stages, were paid by Interstate checks (40). Payroll payments with respect to California operations were apportioned on a revenue motor coach mile basis (40). The findings do recite that taxpayer "paid all of the bills, payroll and otherwise, of Stages" (16).

Revenues, which were collected and retained by Interstate, were allocated on the books by assigning California intrastate revenue directly to Stages (40), and assigning interstate California revenue on a passenger mile basis (16, 40). As already mentioned, revenues thus allocated to Stages in 1936 were $183,365.60, and expenses, so allocated in the same year, were $211,470.59. The correctness of these figures is not disputed. Interstate collected, retained, and had the economic benefit of the $183,365.60 of revenues allocated to Stages (which included the $10,000 of intrastate fares). It also actually bore the economic burden of the expenses allocated to Stages, $211,470.59, which it paid out of its own funds. Interstate would have been compelled to pay these same expense items had there been no intrastate passengers. Interstate, therefore, under the contractual arrangement with its subsidiary, bore the net economic burden represented by the difference in these figures of revenue and expenses, which (disregarding the slight and immaterial adjustment already mentioned) was $28,100.66.

The books of both Interstate and Stages, the latter being kept by Interstate, were on the accrual basis (17). Although there were no money transactions between parent and subsidiary, the subsidiary not having any funds of its own, nor any bank account, all revenues being collected and retained by Interstate and all expenses being paid by

Interstate, yet these accounts contained entries of various inter-company items, including Interstate's allocation as between it and Stages of revenues and expenses, records of cash advances by Interstate with respect to the California operations, and inter-company obligations to one another (compare Petitioner's Exhibits 3 and 4, 43, 44, 61, 62; Hall's testimony, 40-44; 46-48; Respondent's Exhibits A, B and C, 45, 63-67). The mechanics of accounting for the item here involved, the deficit of $28,100.60, are briefly summarized in the findings (16, 17) and covered in some detail by the testimony. The effect of the accounting was that an indebtedness, in form, from Stages to Interstate of some $34,000 was reduced by the application against it of the deficit, which the "absorption" contract required Interstate to assume, so that after application of this amount, the formal indebtedness was reduced to approximately $5,000 (17). The Board of Tax Appeals expressly refrained from passing upon accounting questions incident to the mechanics used; and the subject is only briefly referred to in the opinion of the court below (73). This aspect of the matter is unimportant to a consideration of the questions of law presented for review. Suffice it to say that Interstate made the disbursements for the operating expenses, received the revenues, and actually bore the economic burden of the deficit.

The Board of Tax Appeals decided the case adversely to Interstate upon the ground that the deduction claimed was not an ordinary and necessary expense of its business. The opinion (17-19) recites that the business of Stages was performing intrastate transportation within California, which, it is said, could not have been the taxpayer's business. Stages was said to have been organized not to increase the profits of the taxpayer's business, but to augment its income by increasing Stages' income from intra-

California business.[1] The Board concluded that the taxpayer had not sustained its burden of establishing that any part of this deficit was an ordinary and necessary expense of the taxpayer in the operation of the Interstate business; but the decision is silent upon the two questions of law decided adversely to the petitioner by the court below, and presented here for review. The Circuit Court of Appeals affirmed the Board in an opinion (70-78) which did consider and pass, adversely to the petitioner, on the questions of law now before this Court.

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[1] But the findings recite (15) that Interstate organized Stages "for the purpose of augmenting its income from carrying California intrastate traffic." The testimony on this subject is that the reason for doing so was that Interstate, "through the agency of the California Company, might secure a certificate of public convenience and necessity for the California Commission to handle intrastate passengers within the State of California and thereby augment its gross revenue and its net income" (37). The court below recited (72) that it was "for the purpose of augmenting its income by means of additional revenues derived from carrying California intrastate traffic" that Interstate organized Stages.

SPECIFICATION OF ERRORS.

1. The Court below erred in refusing to hold that payment, under contract, of the subsidiary's deficit, was an ordinary and necessary expense of taxpayer.

2. The Court below erred in holding that the deficit was an incident attributable wholly to the business of the subsidiary.

3. The Court below erred in failing to give effect to the agency relationship between taxpayer and its subsidiary.

4. The Court below erred in holding that payment by the taxpayer of the subsidiary's deficit was a capital expenditure and not an ordinary and necessary business expense.

5. The Court below erred in failing to hold that in the conduct of business within the borders of California, Stages was a mere agent or instrumentality of taxpayer.

6. The Court below erred in affirming the decision of the Board of Tax Appeals.

QUESTIONS PRESENTED.

These are:

1. Whether in the case of a payment, pursuant to a contract obligation, and otherwise representing the ordinary and necessary expense of carrying on a taxpayer's business, by the taxpayer corporation to another corporation through which a part of the paying corporation's business is carried on, but which is measured by the receiving corporation's deficit in carrying on such operations, is a capital or an ordinary expenditure.

2. Whether the "agency doctrine," so-called, by which under certain circumstances, separate corporate entities may be disregarded (which still is invoked at the instance of the taxing sovereignty), may no longer be invoked, at the instance of the taxpayer, and, accordingly, whether numerous past decisions applying this doctrine in taxpayers' favor no longer represent the law.

SUMMARY OF ARGUMENT.

I. As to the First Question:

Mere stock ownership does not entitle a stockholder, even a sole stockholder, to deduct a corporation's deficit; but the facts here establish the deduction as an ordinary and necessary expense; for Stages was Interstate's nominal agent as to California operation. Such operation was actually by Interstate, although nominally that of Stages. The pleadings concede that Interstate was engaged in bus transportation between Chicago and California, and the Court below assumed that Stages was Interstate's agent as to that business, even if local law prevented Interstate

from doing intrastate business except through the medium of a domestic subsidiary (which, if ever the case, was not the case in 1936). Although assuming such agency and treating the expense of intrastate business as insignificant, the Court below denied the deduction upon the ground that it was not dependent upon any corresponding unit of benefit to petitioner or sacrifice of the subsidiary, and consequently said to be an incident attributable wholly to the business of the subsidiary. In thus denying the deduction, apparently because contingent on operating results, the Court below erred. Moreover, the recitals in the absorption contract and in the facts in evidence make it plain, that "sacrifice of the subsidiary" was involved in the arrangement, and that it very definitely was for the "benefit" of Interstate. The deduction was plainly "necessary," and was also "ordinary;" for it was directly related to taxpayer's regular business, and was for a business purpose and no element of a tax avoidance was involved.

Payment of expenditures to and through a wholly owned subsidiary instead directly does not preclude their deduction, if otherwise proper, especially if made pursuant to contract, as was the case here. This Court's decision in *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 8, 78 L. Ed. 212, has no application to the present case and should not be extended to deny the deduction of the economic cost of a normal business operation otherwise clearly deductible. Payment of a subsidiary's deficit, under circumstances such as are here present, is an "ordinary and necessary" expense and not a capital contribution.

II. As to the Second Question:

This question, although often treated as one of "disregard" of separate corporate entities, and sometimes characterized as involving "piercing the corporate veil,"

really is concerned with examination into the true relationships of the entities involved to one another, and other parties in interest. This is not a case of a taxpayer's attempt to repudiate the very entity it has itself set up. The facts establish the relationship of principal and agent, and the fact that such agency exists should be recognized for tax purposes, as in any other case of agency.

The facts of the present case are squarely within *Southern Pacific Company* v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142. They are stronger in favor of the taxpayer than the facts in *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133. Both of those cases are directly contrary to the government contention that in effect would forbid the assertion of a claim of agency, in cases of this general type. The decision of the Court below cannot be reconciled with either the *Southern Pacific* or the *Gulf Oil Corporation* cases. While it is true that the *Southern Pacific* case has often been said to have turned upon its "peculiar facts," the government contention herein and the decision of the Court below would deny relief even where "peculiar facts" exist. In the present case the facts strikingly parallel those of the *Southern Pacific* case, and the present case is also one of "very peculiar facts."

The cases of *Dalton* v. *Bowers*, 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389, and *Burnet* v. *Commonwealth Improvement Company*, 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399, were both cases in which the parties interested had taken inconsistent positions and sought to have the corporate entities disregarded when disregard operated to their advantage, although having availed themselves of the benefit of the corporate fiction where it operated to their advantage. The element of tax avoidance was present in

both cases, which is not true here. *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348, involved a successor corporation and no question of agency, and in addition was a case in which there was a change of control; for creditors succeeded, at least temporarily, to the control of the new corporation, instead of the older corporation stockholders (thus suggesting the analogy of the situation in *Helvering* v. *Alabama Asphaltic Limestone Company*, 315 U. S. 179, 62 S. Ct. 540, 86 L. Ed. Adv. Op. 559). Further, the question involved was carrying forward a statutory net loss of the old corporation, not whether deduction of an out-of-pocket payment by the taxpayer itself should be denied. In that case the deduction claimed had not been actually paid by the taxpayer. The claim was that a predecessor's loss might be deducted, under the terms of a statutory provision conferring the right to a special and unusual deduction. The applicability, of the agency doctrine, was recognized in these cases, and the *Southern Pacific* and *Gulf Oil Corporation* cases were referred to with approval.

The case of *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406, was one in which a loss was not recognized which was claimed in connection with a transaction between an individual and his wholly owned and completely dominated corporation, which in fact functioned as his agent. Except that the interests of the parties are reversed, the case in some respects resembles the present one. The opinion expressly declares that the purpose of the law is "to tax earnings and profits less expenses and losses," and points out that "if one or the other factors in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax paying group." This language makes it plain that actuality, not unreality, should govern,

and that the rule "works both ways." The language relied on by the government, and quoted in the opinion below, in support of the onesided doctrine announced by the Court below was used in connection with this Court's discussion of the *Commonwealth Improvement Company* case, cited by the taxpayer in *Higgins* v. *Smith*, and was directly related to that case and aimed at schemes and sham transactions to escape taxes. *Higgins* v. *Smith* has been cited by the Board of Tax Appeals (*Carling Holding Company* v. *Commissioner*, 41 B. T. A. 493, at page 501) and by the Circuit Court of Appeals for the Tenth Circuit (*Inland Development Company* v. *Commissioner*, 120 Fed. [2d] 986 at pages 988 and 989) in support of contentions of taxpayers asserting the "agency" doctrine. The body of law which is exemplified by the *Southern Pacific* and *Gulf Oil Corporation* cases, and has often, before the decision in *Higgins* v. *Smith*, been applied by both the Board of Tax Appeals and Circuit Courts of Appeals, has not, because of the language in *Higgins* v. *Smith* which is quoted by the Court below, for practical purposes ceased to exist. In the present case the agency relationship should, especially in view of the foregoing authorities, including *Higgins* v. *Smith*, haev been recognized and given effect by the tribunals below

III. As to the Effect of the Relatively Unimportant California Intrastate Operation:

The volume of the intrastate business was but a little over five per cent of the total revenues allocated to California. As to the remainder, almost 95 per cent, the pleadings admit and the Court assumed the agency relationship. Both tribunals below, though not in harmony as to their reasons, gave controlling effect to five per cent of the business, notwithstanding the fact that operating expenses were not increased by the intrastate business

and would have been the same in any event, a fact which the Court below accepted in recognizing the insignificance of expenses occasioned by the intrastate operation. Both tribunals ignored a California statute passed in 1935 which affirmatively permitted foreign corporations engaging in commerce among the several states to transact in California "such commerce and intrastate commerce of like character." In 1936 Interstate had the right under the California law to carry intrastate passengers. Even if it did not, it made, in Nebraska, a valid contract within its charter powers for the nominal conduct by its subsidiary of the intrastate business. Observance of the technical requirements of a state regulatory statute applicable to only a small part of the business carried did not convert what was actually Interstate's business into that of Stages. But in any event the relatively insignificant volume of the intrastate business, the fact that the latter occasioned no additional expense, and the fact that it was but an appendage of the main interstate business, all unite to make the deduction that of Interstate, the principal. The deficit which was part of the economic cost of the enterprise in which Interstate was engaged, namely, bus transportation, was both "ordinary" and "necessary" and should have been allowed as a deduction.

ARGUMENT.

I.

Payment By a Taxpayer, Under Contract, of the Deficit of Another and Legally Separate Taxable Entity Will Constitute an Ordinary and Necessary Expense If in Fact It Is Such an Expense of Taxpayer's Trade Or Business.

Taxpayer Conducted California Operations Through the Employment of Stages, and Expenses of Such Operation Were Taxpayer's Expense.

No contention is made that mere stock ownership entitles the stockholder of a corporation to deduct a deficit sustained by the corporation. If, however, the facts affirmatively establish it, the payment of such a deficit may actually constitute an ordinary and necessary expense. This might be true irrespective of the circumstances of stock ownership. The operations of parent and subsidiary in the present case were closely integrated, as the California operations were actually but a part of the taxpayer's bus transportation business. Stages was in fact no more than an agent or instrumentality of taxpayer, or its *alter ego*. Indeed, the allegations of the petition and the Commissioner's admissions in his answer definitely establish that this is the case as to the interstate business (*supra*, p. 3). This close integration of the two companies greatly strengthens the case for the deduction; but entirely apart from this question, and even if this close integration of the two corporations had not existed, and irrespective of the intercorporate relationship, the assumption by the taxpayer of the 1936 deficit of Stages was, on the facts, plainly an "ordinary and necessary expense" of this taxpayer.

There was in 1936 no prohibition in the California laws against operation by taxpayer of an intrastate bus business. On the contrary the local statute affirmatively permitted it (See Appendix, *infra*, p. 63). This will readily appear from an examination of the California statutes, although this important fact is not mentioned in either the Board's opinion or that of the Court below. Both opinions, and respondent's brief in opposition to the allowance of the writ, erroneously convey the impression that at all times here material Interstate could not lawfully engage in local business. Whatever may have been the case prior to the 1935 amendment of the California law, such was not true in 1936. The taxpayer admittedly was not under any charter restriction against doing an intrastate business, even if the local law had limited the right to engage in such business to domestic corporations. But even if the taxpayer had lacked the legal capacity itself to engage in intrastate business (which appears to have influenced the decisions of both tribunals below), all of the expense items going to produce the claimed deduction would in any event have been incurred in the interstate business, in which taxpayer had the admitted right to engage, and in which it is admitted it was engaged, in 1936 (13). Stages was taxpayer's agent in the conduct of that business, as the Court below correctly assumed (75).

Yet, and notwithstanding recognition, or at least assumption, by the Court below of the fact of such agency, the Court denied to the taxpayer the deduction of the cost of conducting that business. The opinion reasons that the contract obligation of paying the deficit is not placed "upon the ground of payment for any service rendered or to be rendered by the subsidiary," and places great importance upon the fact that "the amount of the deficit to be paid is not made dependent upon any cor-

responding unit of benefit to the petitioner or sacrifice of the subsidiary"; wherefore, the opinion concludes, "the deficit of 1936 was consequently an incident attributable wholly to the business of the subsidiary." This language is not easy to understand. One might characterize it as a *non sequitur*. One may infer from it that the deduction would have been held proper had it represented, let us say, payment of a fixed amount to the subsidiary, instead of one contingent on operating results.

The contract, and the accounting under it, assigned a certain portion of the interstate and all the intrastate revenue to Stages. Such intrastate revenue was but \$10,000 out of \$183,365.60 (34). Also allocated to Stages were certain inescapable expenses, items actually paid by Interstate but under the accounting between the two companies allocable to Stages, which totaled \$211,470.59. The contract required Interstate to bear the burden of the excess of the latter amount over the total revenues. But for the \$10,000 of intrastate revenue, the net expense items, in that case assignable beyond question to taxpayer's interstate business in their entirety, would have been \$10,000 more.

The claimed deduction was, therefore, obviously "necessary." If taxpayer had contracted with some private individual to operate taxpayer's buses while in California and account to the taxpayer for earnings, any amounts paid such individual by way of reimbursement for the excess of expenses over revenues, and for compensation, if any, would constitute "ordinary" as well as "necessary" expenses. There are doubtless situations under which payment of a subsidiary's deficit may constitute a capital contribution. The present case, however, is one in which the deficit is directly and intimately related to the taxpayer's regular business operations.

The emphasis on petitioner's supposed incapacity itself to engage in intrastate operations ignores the relative insignificance of the intrastate business (less than one-eighteenth of the total California revenue and adding nothing whatever to the total expense). Further, such incapacity, even if it existed, ought not to preclude such a deduction as a business expense. Thus, if Interstate were to extend its line from Los Angeles to the Mexican border, and beyond, for example to Ensenada, Mexico, but, to comply with Mexican law, were compelled to conduct operations south of the border through a Mexican subsidiary under a similar arrangement, would not a deficit of the latter constitute a business expense, as the term is ordinarily understood, in its common everyday significance? Interstate in such a situation would not be merely investing in the subsidiary, for the purpose of enabling the subsidiary to profit. Considered separately, such ventures are often, perhaps usually, unprofitable; but they may be thought advantageous to the enterprise as a whole. Obviously such a venture would not be undertaken except as part of the principal business activity of the parent. This was true of Stages.

Interstate did not, as the Court below erroneously reasoned, organize Stages so that the latter, separately considered, would be a profitable business venture in the intrastate field.[1] The uncontradicted evidence is to the contrary. The absurdity of such a contention is apparent from the figures of relative revenues. Stages was organized to enable Interstate to benefit from the additional local revenue obtainable if local business could be con-

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[1] This is true, in spite of the fact that the Board's decision was against the taxpayer. The extent to which some of the language in the Board's opinion is contrary to the evidence is discussed below, pp. 57, 59. The statements in the text above are supported by Haugh's uncontradicted testimony (34, 35). Compare also the text of the absorption contract (57) already mentioned (*supra*, pp. 5, 6).

ducted. Having been organized for this purpose, it was also a convenient agency for the nominal conduct of taxpayer's interstate operation in California. The latter operation furnished seventeen eighteenths of all California revenues, and required the expenditure of all of what was paid out for operating expenses. The absorption contract, made in 1932 when there could have been no possible object, so far as taxes were concerned, to misstate the relationship of the parties, recites that Stages was maintained as an operating subsidiary of Interstate, and that its operations were conducted "solely for the benefit of" Interstate, and evidences a purpose that Interstate "may obtain the greatest benefit from the operations of the California corporation," and that in order to get this benefits chedules of the two companies must be coordinated and Stages must "operate on such routes and upon such schedules as will most greatly benefit" Interstate. There is the further recital that "such operation may not be so remunerative to the California corporation as operation solely for its own corporate benefit." This recital alone negatives the assertion of the Court below (*supra*, p. 21) to the effect that "sacrifice of the subsidiary" was not reflected in the deficit. Where an unprofitable subsidiary is thus organized for a business purpose and with no element of tax avoidance involved, as an incident of a main business enterprise and to further that enterprise, it ignores realities to say that a non-capital deficit borne by the parent is not an "ordinary and necessary expense" of the parent.

Payment of Another's Obligation Or Deficit Is a Proper Deduction If Related to Taxpayer's Trade Or Business and Non-Capital in Nature.

Taxpayer's contention on this point has been well stated in a memorandum opinion rendered, in another case, by the Board of Tax Appeals several months after

its decision in the present case, but by a different member. It is now referred to, not as an authority, but because its reasoning, which petitioner herein adopts, expresses succinctly the argument for allowing the deduction. The case is that of *Shasta Water Co.* v. *Commissioner,* Docket No. 102772, not reported officially but available in the Commerce Clearing House Board of Tax Appeals Service as Decision 12411-B. There the taxpayer produced and sold Shasta Springs Mineral water. As an incident to its business, it operated a resort hotel near Mount Shasta, California, on the property on which the springs were located. The hotel was transferred to a wholly owned subsidiary, and because it was anticipated that the subsidiary would lose money the taxpayer agreed with its subsidiary to pay the latter's losses sustained in the operation of the hotel, in exchange for advertising the taxpayer would receive by reason of such operation. The Board held that the payment of the subsidiary's loss pursuant to that contract constituted an "ordinary and necessary" expense. The decisions in the *Shasta* and the present case cannot be reconciled.

The opinion in the *Shasta* case, making no mention of any question of disregard of corporate entity, after pointing out that the record made it clear that in the particular business in which the taxpayer was engaged such a type of advertising was usual and saying that therefore such expenditures were ordinary and necessary business expenses, said further:

> "The fact that these expenditures were made to a wholly owned subsidiary for the purposes of providing for the operation of such a hotel, instead of being made directly by petitioner on account of its own operation of the hotel, can not preclude their deduction. The deduction by a corporation of proper

business expenses paid to subsidiaries for value received does not constitute the filing of consolidated returns or amount to the shifting of profits and losses at will for Federal income tax purposes."

This is substantially the situation in the case at bar. The type of expenses assumed under the "absorption contract," which taxpayer seeks in this proceeding to be permitted to deduct, were of a nature usual and customary, and "ordinary," and certainly "necessary," in the bus transportation business. The California corporation agreed to operate the buses upon such routes and schedules, and under such operating rules and regulations as might be directed by taxpayer, which in turn agreed "to assume and reimburse the California corporation for any deficits incurred by the California corporation in its operations"; and the latter agreed to pay over to taxpayer any profits. There was no voluntary payment of another's expenses; there was a formal assumption, in 1936, in accordance with the formal contract, of certain expenses of a subsidiary, in excess of revenues, in performing a normal and ordinary operation in connection with taxpayer's business. The taxpayer itself actually disbursed the money, and received the revenues. If the intrastate passengers had not been carried, the taxpayer would have had a lower over-all net taxable income; for the expenses of the California portion of the interstate trip would have been no less, but the net deficit allocable to California would have been greater because of the absence of any California intrastate revenues. To assert that this is not an "ordinary and necessary expense" under these circumstances is to close one's eyes to actualities.

In the present case both the Board of Tax Appeals and the Court below relied on this Court's decision in *Welch* v. *Helvering,* 290 U. S. 111, 54 S. Ct. 8, 78 L. Ed.

212, for the general proposition that one taxpayer is not entitled to a deduction for another's expenses voluntarily assumed. There this Court held that the voluntary payment of a debt for which one was not liable, but which was paid for the purpose of strengthening one's business credit, was not, however "necessary," an "ordinary" expense, and was rather in the nature of a capital expenditure. The opinions below would extend the principle of that case to deny the deduction in the present case of the economic cost of a normal business operation otherwise clearly deductible. In the *Welch* case (which is not at all in point here), this Court observed that payment of another's debts "instead of being ordinary is in a high degree extraordinary," and that "there is nothing ordinary in the stimulus evoking it, and none in the response." Conversely, it may be said with equal truth that corporations "ordinarily" do pay expenses, especially of their own subsidiaries, incurred for their benefit. Here the expenses sought to be deducted were current expenses of an existing operation, in a year in which that operation happened to produce a deficit.

There is no decision by this Court of the question whether, upon facts such as are here presented, payment of a subsidiary's deficit constitutes an "ordinary and necessary expense" of the parent. While undoubtedly such a payment by a stockholder is often in fact a capital contribution, the decisions below in effect hold that a parent corporation is estopped ever to establish factually that such a payment is a business expense. Upon this branch of the case petitioner submits that sound reason and logic, and the consideration that actual net income only be subjected to present day high corporate tax rates, compel a reversal of opinions of the tribunals below on this question.

II.

The Close Integration of the Taxpayer and Its Subsidiary Make It Plain Beyond Question That Stages Was But an Agency Or Instrumentality of Taxpayer.

The opinions below exhibit much confusion on the agency question. Thus the Board's opinion stresses Stages' "separate juristic taxable entity" and adds that "the bus business of Stages, limited as it was to the State of California, did not become that of petitioner by virtue of petitioner's sole ownership of the stock of Stages" (18). The Circuit Court of Appeals assumed the agency as to the interstate traffic (75); and yet in the very next paragraph the Court below apparently has rejected its own assumption and refused to apply the doctrine that close integration of parent and subsidiary may, under some circumstances, require treatment of the subsidiary as but an agency or instrumentality. In this connection, and overlooking its own acceptance of the contention that the expense of carrying intrastate traffic is insignificant and that Stages was taxpayer's agent as to the interstate traffic, the Court below says that the subsidiary "was organized primarily to do a business which petitioner had no authority to do." Nor is there in the opinion any mention of the fact that, whatever the pre-1935 law in California, there was no legal obstacle in 1936 to taxpayer's conduct in that State of local transportation.

Cases dealing with the subject of "piercing the corporate veil" contain language to the effect that the separate entity will in a proper case be "disregarded." Perhaps a better approach would be not that of "disregard," but of examining into the true relationships of the entities involved to one another and other parties

in interest.[1] Where the taxing officers seek to "disregard" the entity, the taxpayer relying on it may be prevented for some reason from benefiting by it. That was the case in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406. Or the taxpayer may, in spite of the form employed, not have accomplished his purpose. Compare *Gregory* v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596. Here, in a sense, the taxpayer asks that the fiction be "disregarded." It would, however, be more nearly accurate to say, not that the present taxpayer is seeking to repudiate the very entity it has itself set up, but that the present relationship is, on the facts, that of principal and agent, and that, upon principles familiar in the law of agency, all that is asked is that the actual fact of agency be recognized for tax purposes, just as it would be in any other relationship. There is no rule of law preventing a corporation from being an agent if it is one in fact. Even the opinion below assumed that Stages was Interstate's agent in the conduct of the interstate operations.

Precedents prior to Higgins v. Smith favorable to taxpayer's contention.

There are three important decisions, in tax cases, by this Court dealing with such situations. These are:

Southern Pacific Co. v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142.

Gulf Oil Corporation v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133.

Weiss v. *Stearn*, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001.

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[1] Thus the present taxpayer frankly recognized before the Board of Tax Appeals that Stages was a separate "entity" (25).

No contention is made (as the opinion below suggests, 130 Fed. [2d] 136, at p. 140; Rec. p. 76), that these (and decisions of lower courts following them) lay down "any general rule authorizing disregard of corporate entity in respect to taxation." Petitioner recognizes that a corporation is an entity separate from its stockholders. The question here is whether it should be recognized that the subsidiary is but an agency of the parent. The Government's position is that such agency can never be recognized at the taxpayer's instance.

Southern Pacific Co. v. *Lowe* was an action to recover income taxes paid, under protest, upon certain dividends upon stock of the Central Pacific Railroad owned by the Southern Pacific. The dividends were received in 1914, but were alleged to have been paid out of a surplus accumulated prior to the effective date of the income tax act, and of the sixteenth amendment. The Southern Pacific was the sole stockholder of the Central Pacific, and in actual physical possession of the railroads and assets of the Central Pacific, and in charge its operations, which were conducted in accordance with the terms of a lease to the Southern Pacific, one of whose terms was that the Southern Pacific pay lessor \$10,000 per year for organization expenses, should operate the road and account annually for net earnings, and, if these exceeded six per cent on lessor's stock, half the excess should be retained by lessee. Advances by lessee for lessor's account were to bear interest. Lessee Southern Pacific was entitled at any time and from time to time to refund to itself its advances and interest out of any net earnings that might be on hand. These provisions were observed for bookkeeping purposes. Southern Pacific acted as cashier and banker for the entire system. Central Pacific had no bank account.

Its earnings were deposited in Southern Pacific's account. If Central Pacific needed funds, they were advanced by Southern Pacific. As a result of these operations and of the conversion of certain capital assets of Central Pacific, that company had a large surplus on its books accumulated prior to January 1, 1913. The dividends in question were declared and paid in 1914 out of this surplus. The payment was however constructive only, and was carried into effect by bookkeeping entries reducing the surplus and reducing the indebtedness of Central Pacific to Southern Pacific. The question was whether such dividends constituted income under the 1913 income tax law. Such dividends, paid out of surplus that accrued prior to 1913, this Court said accrued to Southern Pacific prior to that date "in every substantial sense * * * and hence underwent nothing more than a change of form when the dividends were declared." The following language in the opinion is particularly pertinent to the present inquiry:

> "We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, *acting merely as its agent and subject in all things to its proper direction and control.* And, besides, the funds repre-

sented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends. The fact that the books were kept in accordance with the provisions of the lease, so that these funds appeared upon the accounts as an indebtedness of the lessee to the lessor, cannot be controlling, in view of the practical identity between lessor and lessee. Aside from the interests of creditors and the public—and there is nothing to suggest that the interests of either were concerned in the disposition of the surplus of the Central Pacific—the Southern Pacific was entitled to dispose of the matter as it saw fit. There is no question of there being a surplus to warrant the dividends at the time they were made, hence any speculation as to what might have happened in case of financial reverses that did not occur is beside the mark. * * * " (Italics ours.)

The opinion concludes with the statement that it turns "its very peculiar facts," which facts, however, were held sufficient to make the subsidiary but an agent. It has sometimes been said that the case is distinguishable on the ground that the subsidiary's earnings had become capital before the sixteenth amendment. But in the very next case in the same volume of the reports, *Lynch* v. *Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, this Court held that the circumstance that the dividends had been earned before March 1, 1913, did not avoid the tax.

Southern Pacific Co. v. *Lowe* was explained in a case decided the same day by this Court, *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, in the following language:

> "*Southern Pacific Co.* v. *Lowe*, has been reversed this day, *ante*, 330, but only upon the ground that the Central Pacific Railway Company, which paid the dividend, and the Southern Pacific Company,

which received it, were in substance identical corporations because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely *as its agent* and subject in all things to its direction and control; and for the further reason that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend. * * *" (Italics ours.)

The present case involves a deduction from income, not whether an item is includable in gross income. Otherwise the cases are very similar. Thus in each we have these elements:

1. One hundred per cent stock ownership.

2. Physical possession of the assets (except for Stages' nominal "possession" of the buses while in California).

3. Central direction of the entire enterprise in the parent's interest.

4. Absence of any bank account by the subsidiary, the parent acting as banker.

5. Retention of all revenues and payment of all expenses by the parent.

6. Formal leases, and formal accounting, between parent and subsidiary. In the *Southern Pacific* case the lease ran from subsidiary to parent; in the present case the "operating agreement" is in form bilateral: but Interstate actually conducted the operations, paid the help, and was as much in direct control of the California operation as was Southern Pacific of the operation under lease of Central Pacific's property.

The case of *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133, was a stronger case for the Government than either the *Southern Pacific* or the present case. It is of especial interest because the opinion was written by the late Mr. Justice Holmes, whose insistence on cutting through mere form and recognizing actualities is well known. The opinion is characterized by his familiar brevity, terseness and directness of expression. The taxpayer was a corporation holding stock in other corporations, which, together, like the corporations involved in the present case, constituted a single enterprise, carried on by the taxpayer, which was that of dealing in various phases of the oil business. The subsidiaries retained their earnings, although making some loans among one another, and their funds were invested in properties or required to carry on the business, so that the debtor companies had no money to pay their debts. In January, 1913, the taxpayer decided to take over the previously accumulated earnings and surplus and did so by votes of the companies it controlled. The question was whether the parent was taxable upon dividends, so-called, declared as part of this transaction, and paid, not in cash but by adjustments of the intercompany accounts. Justice Holmes pointed out that the taxpayer "was no richer than before, but its property was now represented by stock in and debts due from its subsidiaries. * * *" He pointed out that "it is true that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the facts that they were related as parts of one enterprise, all owned by the petitioner, that the debts were all enterprise debts due to members, and that the dividends represented earnings that had been made in prior years and that practically had been converted into capital,

unite to convince us that the transaction should be regarded as bookkeeping rather than as dividends declared in the ordinary course by a corporation." He pointed out further that although "the petitioner did not itself do the business of its subsidiaries and have possession of their property as in *Southern Pacific Co.* v. *Lowe*," yet "the principles of that case must be taken to cover this."

The case for the Government's sweeping contention is outlined in the opinion of the court below in the *Gulf Oil Corporation* case, 245 Fed. 1. With a few modifications of detail, that opinion fits the Commissioner's position in the present proceeding. Yet, Mr. Justice Holmes, speaking for this Court, who concurred in the unanimous opinion in *Southern Pacific* v. *Lowe*, rejected the argument for unreality in favor of the argument for reality. It is difficult to discern a basis of reconciliation between the respondent's position in the present case and that announced by Mr. Justice Holmes in his *Gulf Oil Corporation* opinion.

Examination of the Government's brief in the latter case is enlightening because of the distinctions claimed to exist between its facts and those in the *Southern Pacific* case. The facts of the instant case are closer to the more favorable (to the taxpayer) *Southern Pacific* case than to the *Gulf Oil Corporation* case. Indicative of the striking factual similarity between the "peculiar circumstances" of the *Southern Pacific* case and of the present case is the attempted distinction urged in the Government's brief in the *Gulf Oil Corporation* case between that case and the *Southern Pacific* case. Commencing on page 8 of its brief in that case, the Government quoted the language from *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, that has al-

ready been set out above (p. 31), and then asks "what, then, are the 'very peculiar facts' referred to by the Court as taking the *Southern Pacific Company* case out of the general rule?" The brief then enumerates four:

1. The lease whereby the subsidiary is said to have "divested itself of the custody of all its property, so that it had nothing which could be the basis of any dealings with any person except the holding company." Here Stages' two buses were "leased" to Interstate outside of California, and Interstate's buses were "leased" to Stages in California, where they were operated for Interstate's benefit. Stages can hardly be said to have had anything "which could be the basis of any dealing with any person except the holding company."

2. The Management, of which the Government's brief quite properly said, as it could also be said of the management in the present situation: "The court was not dealing with the case where a subsidiary's board of directors, though reflecting the policy of the controlling corporation, actually manages its business. The lease to the holding company left nothing to manage, everything was done by the holding company, not as agent, but in its own behalf." The same situation obtains here.

3. The source of money, as to which the brief points out that the case was not one where the subsidiary collected money in a regular course of business dealings, but on the other hand, that the subsidiary was not a party to any contract with any person except its holding company, nor did the general public have any dealings with the subsidiary, whose only source of income was rent, graduated according to earnings, paid by the holding company. In the present case, the form is slightly different, but the substance is about what it was in the *Southern Pacific* case. Here Interstate's leases of the Los Angeles bus Ter-

minal and the garage were in form transferred to Stages; but Stages, which never had any bank account, necessarily never could carry on any business with the public except nominally.[1] Even the interests transferred to Stages (including the ticket selling agencies and the like) were arranged for with the outside parties by Interstate so that Stages' formal interest came about as a consequence of an inter-company transaction.

4. The character of the dividends, which were only a book transaction, not only in the sense that the holding company kept the funds, but because the subsidiary, since it had cut off all active business, had collected no money, and because it was the holding company that was in business for itself, utilizing the plant of the subsidiary as part of its system, and money was received by the holding company in its own behalf, except that at one time it was credited to, at another, charged against, the subsidiary's account. Substantially the same situation exists here.

The Government then conceded that such a situation called for different treatment from the situation in which the subsidiary deals directly with the outside world (as did the subsidiaries in the *Gulf Oil Corporation* case) in managing property and affairs. Nevertheless, the opinion of Mr. Justice Holmes recognizes the essential reality, which was that these subsidiaries functioned merely as agents, so that what they did was in essence what the principal did, and therefore, that, whatever the form, the agency relationship was the reality. If the Government's brief correctly conceded that the facts in *Southern Pacific Co.* v. *Lowe* were "very peculiar," the same logic requires recognition that the present is also a case of "very peculiar facts."

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[1] See above, p. 8, footnote.

The case of *Weiss* v. *Stern*, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001, goes farther on the side of the taxpayer. Both Mr. Justice Holmes and Mr. Justice Brandeis dissented in this case, a circumstance that adds force to the views in which both concurred in *Southern Pacific* v. *Lowe*, and which Mr. Justice Holmes expressed and in which Mr. Justice Brandeis concurred in *Gulf Oil Corporation* v. *Lewellyn*. In *Weiss* v. *Stern* suit was brought to recover taxes alleged to have been overpaid in respect of the sale by the taxpayers of certain transactions in the stock of a business corporation. The question was whether they were taxable on the profit on all or only half of their interests. They delivered certificates representing the entire capital stock of the corporation to a depositary trust company, with which was also deposited by certain bankers, for purchasers, a large sum of cash. Both classes of depositors caused a new corporation to be formed, which took over the assets of the first named company and assumed its debts, and in payment issued to the trust company its authorized capital stock. The old corporation was dissolved. The trust company delivered to the bankers half this new stock, and delivered the other half *pro rata* among the owners of the old stock, the taxpayers involved, together with all the cash; so that the effect of the transaction was that each former holder got half the interest he formerly had, plus cash. The Collector ruled that the transaction was a sale of the entire holding, in each case; the courts below held that the sale was of but the half; and this Court upheld that view. This Court cited the *Southern Pacific Co.* and *Gulf Oil Corporation* cases for the proposition that mere change for purposes of reorganization in the technical ownership of an enterprise, under such circumstances, did not constitute gain.

Petitioner appreciates that some more recent cases (for example, *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348, *infra*) may have weakened somewhat the authority of *Weiss* v. *Stern;* but if the case is recognized as a controlling authority, then, *a fortiori,* the present case was wrongfully decided below; while on the other hand the obvious differences between the two cases, and the fact that the dissenting justices participated in the *Southern Pacific* and *Gulf Oil Corporation* decisions, one of whom wrote the opinion in the latter case, emphasizes the importance of these two decisions as precedents governing the present case.

Southern Pacific Co. v. *Lowe* and *Gulf Oil Corporation* v. *Lewellyn* have at times been distinguished, where the facts were different; but they have been many times cited with approval, and the principle applied in each of them has been generally approved and recognized in the later cases. They cannot be reconciled with the Government's contention in the present case, nor with the views of the Court below on this aspect of the case. Nor, it is submitted, can they be factually distinguished from the facts of the instant case. If they are still recognized as correctly stating and applying the law to such facts, the same result must follow in the present case.

Precedents Prior to Higgins v. Smith Cited for the Government Contention.

Of the many cases which have applied the familiar rule that a corporation is an entity separate and apart from its stockholders, three decisions by this Court are often cited in opposition to the application of the "agency" doctrine are: *Dalton* v. *Bowers,* 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389; *Burnet* v. *Commonwealth Improvement Company,* 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed.

399, and *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348. The two last mentioned were cited in the respondent's brief in opposition to the allowance of the present writ.

In *Dalton* v. *Bowers*, Dalton, the taxpayer, who had a large private income from various sources, busied himself for some twenty-five years with physical research and invention. His inventions brought him no profit. Patents covering his inventions he transferred to a corporation organized by himself, all of whose stock was paid for by him, and of which he was director, president and treasurer. He was in control of its affairs. No other person was financially interested. He testified that his purpose in this venture was to perfect his models and patented articles and sell the corporate shares profitably. He thought it would be better to market his inventions through the corporation, which he considered a branch or a part of his business as an inventor, as a means to an end, an instrumentality of his purpose. He also testified that he believed it essential thus to have his inventions manufactured and brought before the public, and that the corporations were used in order to develop and improve his inventions. The corporation took over certain patents, manufactured the articles, and tried to sell them; and Dalton tried to sell the corporate shares and thereby obtain gain. From time to time he advanced large sums to pay its debts and carry on the corporate business, which loans appeared on the corporate books but were not repaid. Credits were placed to his salary but he withdrew nothing. In 1924 the corporation became insolvent and in 1925 passed out of existence. There had been losses for several years. Dalton paid all the creditors. The corporation and Dalton filed separate income tax returns; and in 1923 and 1924 Dalton claimed

large deductions (over $150,000 in each year) on account of bad debts due from the corporation. In the personal return for 1925 Dalton claimed a deduction of $495,000 which he paid for the worthless shares of the corporation; and the Commissioner ruled that this loss had occurred in 1924. Adjustments for that year produced a large net loss by Dalton, which the Commissioner refused to apply upon the 1925 return because it was not attributable to the operation of a trade or business regularly carried on by the taxpayer. Dalton contended that the loss of 1924 was sustained in a trade or business and that therefore the net loss for 1924 should have been carried forward under the carry-over provisions permitting a carry-over in the case of a loss attributable with a trade or business regularly carried on by the taxpayer. This Court affirmed the Circuit Court of Appeals' decision denying the net loss carry-over.

Dalton's contention, as summarized in this Court's opinion, was that the corporation's entity constituted a part of Dalton's individual trade or business, which was not merely that of inventing but included exploiting of the inventions and selling them through corporations, all of which things were claimed to form a complete, comprehensive enterprise of which the taxpayer corporation was part, as an instrumentality of Dalton's business, so that the investment in the corporate shares was part of a business regularly carried on. This Court disposed of the foregoing contention by pointing out that it rested upon assumptions out of harmony with the facts. Dalton was said not to be regularly engaged in the business of buying and selling corporate stocks. He organized the corporation and took over its shares with the intention of selling them at a profit. The opinion points out that Dalton treated the corporation "as something apart from

his ordinary affairs"; for he accepted credits for salaries, claimed a loss to himself because of loans to it which had become worthless, and caused it to make separate corporation returns. It was said that nothing indicated that Dalton regarded the corporation as his agent with authority to contract or act in his behalf; for ownership of all of the stock was not enough to show that creation and management of the corporation was a part of his ordinary business. The concluding sentence of the opinion is to the effect that "certainly, under the general rule for tax purposes a corporation is an entity distinct from its stockholders, and the circumstances here are not so unusual as to create an exception."

The mere recital of the facts of that case makes it clear how different was the situation presented by that record and the record now here for review. The contention that the corporation was an instrumentality appears to have been based on Dalton's subjective testimony as to what he considered the corporation to be. As the opinion points out, this subjective testimony failed to meet the objective test of Dalton's own actions. The last sentence in the opinion recognizes that there may be an exception where the circumstances are "unusual." The case is nothing more than the application of the familiar rule that mere ownership of stock does not make the corporation's business that of the stockholder.

The *Commonwealth Improvement Company* case, as respondent's brief in opposition to the allowance of the present writ points out (on page 8), was the subject of construction by this Court in *Higgins* v. *Smith*. The taxpayer in *Higgins* v. *Smith* had relied heavily upon the *Commonwealth Improvement Company* case; and the discussion of that case was the direct occasion for the expression of the dictum in *Higgins* v. *Smith* to the

effect that the taxpayer must accept the tax disadvantage of the form of organization he has chosen. The taxpayer in the *Commonwealth Improvement Company* case, a corporation all of whose shares were owned by the Widener Estate (Widener having died in 1915), claimed a deduction on its 1920 income and excess profits tax return for a loss occasioned by the transfer of certain stock to the Estate. The Commissioner refused to allow the deduction and found, instead, that the transaction yielded gain to the corporation. Widener during his lifetime had conveyed to the corporation various stocks, of a large aggregate value, in exchange for its securities. At the time, he was old, and his purpose was to avoid manifold death duties or transfer taxes, and also to insure the safety of an endowment he wished to donate to a favorite charity. Among the securities so transferred by Widener to the corporation were the shares of stock in question. In 1920 a transaction between the trustees of the Estate and the corporation included the transfer to the Estate of the shares in question. The apparent result of the transaction, as the taxpayer returned it, was a net loss, for which the corporation claimed a deduction; but the Commissioner's audit, because of an adjustment made by him to allow for the exercise by the corporation of certain rights to subscribe for new stock, indicated a large gain, in excess of $1,000,000, for which the Commissioner made a deficiency assessment. The taxpayer contended, in the litigation, that under the peculiar facts of the case the transaction resulted in no true loss or gain, it being contended that the corporation was merely the agency or instrumentality of the trustees of the Estate, and that practically the Improvement Company and the Estate were one entity. The opinion of this Court expressly approved the language used by the Board of Tax Appeals which

pointed out that if the taxpayer's contention were logically applied, all income received by it since its organization had been properly taxable as Widener's income and that of the Estate, and should have been added to other income of Widener and the Estate during these years and taxed at the rates applicable to individuals rather than at the corporate rates (one may infer that the income which would have been thus subject to taxation at individual rates would have been in brackets carrying higher rates than the then current corporation rates). The Board was also upheld in saying that for purposes of inheritance and transfer taxes imposed by the various states on the transfer of the stock the corporate entity should have been disregarded at Widener's death, and the stocks subjected to whatever taxes would have been payable had they been owned by Widener. The Board pointed out that the taxpayer "does not seek to carry its contention to such a conclusion," and was upheld by this Court in saying that "having enjoyed the benefits which resulted from its separate existence, it (the corporation) seeks to perpetuate those benefits and asks that the separate existence and tax liability of the petitioner and its single stockholder be overlooked only with respect to transactions which take place between them," which was said to be "an afterthought" which was "plainly evidenced by the action of petitioner in claiming a deduction upon this same transaction when it believed a deductible loss had been sustained."

After thus approving the foregoing expressions by the Board of Tax Appeals, this Court recited that the counsel for the taxpayer had cited *Southern Pacific Co.* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn* "not as controlling but as instances where the court looked through mere form and regarded substance"; and then expressly recognized that "unusual cases may require disregard

of corporate form," but said that the record in the case then before it failed to disclose any circumstances sufficient to support the taxpayer's claim. It was specifically pointed out that the corporation was "avowedly utilized to bring about a change in ownership beneficial to the latter (the Estate)"; and that "for years they were recognized and treated as different things and taxed accordingly upon separate returns." The opinion concludes by referring to *Southern Pacific* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn* (the latter being said to be "covered in principle by the former") as presenting "peculiar situations." *The Commonwealth Improvement Co.* case falls far short of supporting the Government's contention in cases like the present one. What it held was that a taxpayer corporation organized for the express purpose of minimizing inheritance and transfer taxes, which had for a number of years been regarded by those interested in it as a separate entity for tax purposes as well as other purposes, and which had in respect of the very transaction under review claimed a loss when it thought a loss had been sustained, was estopped to disavow its independent status when that status produced an unfavorable tax result.

The *New Colonial Ice Company* case was one in which all the assets and business of an older corporation were taken over by a new corporation specially organized for the purpose, with substantially the same capital structure, in exchange for a portion of its stock, which was distributed by the older corporation among its shareholders, thereby retiring the old shares. The question was whether the new corporation, notwithstanding the change in corporate entity and ownership, was entitled to have its taxable income for the succeeding period determined by deducting from net income for that period the net losses sustained by the older corporation in the

preceding period. The case resembles that of *Dalton* v. *Bowers* in that, like that case, the net loss carry over section of the revenue laws was involved.

The old corporation had become financially embarrassed and was unable to meet its indebtedness or supply additional equipment needed to render the business profitable. Creditors' and stockholders' committees were organized; and investigation disclosed that there was considerable spurious stock outstanding. Negotiations resulted in the restoration and cancellation of the spurious stock and an agreement to organize a new company to take over the old company's assets and liabilities, which proceeded with the completion of the equipment and continued the operation of the business. An issue of stock by the new company was to be made to the old, equal in class, par value and number of shares, so the old company could exchange the new stock share for share with its stockholders and retire the outstanding stock. Provision was also made for obtaining new funds, for an extension of time by existing creditors, and for giving creditors a supervising management through a voting trust until their claims were paid. The new corporation was accordingly organized, and took over the assets, liability and business of the old. Although the corporate existence of the old corporation continued for a short time thereafter, it transacted no business after the transfer, and had no assets or business. The old corporation had sustained statutory net losses during 1921 and 1922. The new corporation, which took over in April of 1922, realized a net income during 1922 and 1923 and asserted the right under the applicable internal revenue law to a deduction from its income of the losses sustained by the old corporation, insisting that the continuity of the business was not broken by the transfer from the old company to the new.

This court, in denying the taxpayer's contention, pointed out that the continuity had been accomplished by deliberate elimination of the old company and substitution of the new, and then discussed the essential difference between the stockholders and creditors on the one side and the corporations involved on the other. The opinion points out that deductions are allowed only as a matter of legislative grace, and that only as there is a clear provision therefor can any particular deduction be allowed. Reference was also made to the fact that the computation of gains and losses for income tax purposes is "on the basis of a distinct accounting for each taxable year," and that only in exceptional situations, said to have been clearly defined, had there been provision for an allowance suffered in an earlier year. The opinion points out that the statutes had disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, that is, to treat them as personal to him and not transferrable to or usable by another. Accordingly, it was then said, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. Referring then to the special provision for the carrying forward of net losses, the opinion refers to this provision as "exceptional." Its words were said to be plain and free from ambiguity, and that, taken according to their natural import, it meant that the taxpayer by whom the loss was sustained the loss was the one to whom the deduction should be allowed. The section was construed as not intended to make a departure of the kind there urged by the taxpayer.

The opinion then proceeded to take up the taxpayer's alternative contention that the deduction should be allowed because for all practical purposes the new corpo-

ration was the same entity as the old one and therefore the same taxpayer. In this connection the opinion points out that this contention was, however, "not in accord with the view on which the stockholders and creditors proceeded when the new company was brought into being," for "they deserted the old company and turned to the new one because they regarded it as a distinct corporate entity and therefore free from difficulties attending the old one." It was then said that "they had sought and reaped the advantages incident to the change." Although the opinion does not mention it, there was a change in the immediate control; for the voting trust provided for the substitution, for a time at least, of creditor control for stockholder control. (Compare *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U. S. 179, 62 S. Ct. 540, 86 L. Ed. Adv. Op. 559). The distinct entities of the two corporations were said to have been "plainly implied in the transfer of the assets and business from one to the other," a transfer which was voluntary and contractual and not by operation of law. Then follows this significant sentence:

> "Thereafter neither corporation had any control over the other; the old corporation had no interest in the assets or business, and the chance of gain and the risk of loss were wholly with the new one."

In using this language, which makes it plain that there was no agency relationship between the two corporations, the opinion makes a footnote reference to *Southern Pacific* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn*, and also cites in the same connection *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, (with special reference to 247 U. S. 347 at page 349, at which appears the language explaining *Southern Pacific* v. *Lowe* which has already been quoted, *supra*, page 31). In denying the contention thus made, in this *New Colonial Ice Company*

case, there is, however, the following express recognition, although stated in terms of "disregard" of the corporate entity, of the agency doctrine:

> "Of course, the rule (that a corporation and its stockholders are separate entities) is subject to the qualification that the separate entity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of private rights."

For this statement footnote reference is made to several decisions of this court, in which were again included both *Southern Pacific* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn.*

Dalton v. *Bowers, Burnet* v. *Commonwealth Improvement Co.* and *New Colonial Ice Co.* v. *Helvering,* and cases like them, do not, therefore, support the contention that in effect would never recognize the agency doctrine in a case where on the facts a corporation, though a separate entity, is actually but an agency or instrumentality. Further, the factual distinctions between each of these three cases and the case now under review, and language used in the opinion support the petitioner in the present proceeding.

The case of Higgins v. Smith.

In this case it was held that an individual taxpayer could not take a deduction for an alleged loss occasioned by a transaction between himself and his wholly owned and completely dominated corporation, which the opinion terms the taxpayer's "corporate self." Although there is no reference in the opinion to the subject of the corporation's agency for the taxpayer, the facts indicate an agency relationship; but the interests of the parties were the reverse of what they are in the present case.

The individual, the taxpayer, one Smith, organized a corporation whose officers and directors were his own subordinates, and whose transactions were carried on under his directions and were restricted largely to buying securities from and selling to Smith himself. The corporation was created to gain advantages for Smith in the form of income and estate tax savings. The action was brought in one of the District Courts and tried before a jury, which rendered a verdict adverse to Smith's claim that purported sales of securities to the corporation marked the realization of loss on their purchase. The jury had been instructed to determine whether the transfers were "out of" Smith and "into something separate and apart from him," or were simply transfers from his left hand, his individual hand, into his right hand, his corporate hand, "so that in truth and fact there was no transfer at all." A judgment pursuant to this verdict was reversed by the Circuit Court of Appeals; but the decision of that court was in turn reversed by this court.

The opinion says among other things that there was sufficient evidence to support the verdict, and adds that the domination and control was so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense (that the loss is sustained when realized by a completed transaction determining its amount) could occur upon a sale by a taxpayer to such an entity. *Gregory* v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596, was referred to as a precedent for "the disregard of a transfer of assets without a business purpose but solely to reduce tax liability," which was said to give support "to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." The dicta quoted in the

opinion below of the Eighth Circuit Court of Appeals and quite generally relied upon by the Government in this class of case, which were in connection with this Court's discussion of the *Commonwealth Improvement Company* case and when read together with the context are clearly limited in their application to situations of that kind, follow the following pertinent language:

> "There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax *earnings and profits less expenses and losses.* If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group."

The foregoing language makes it plain that *Higgins v. Smith* does not sanction the one-sided doctrine relied on by the Government and upheld by the court below. Included in the total revenues collected by the taxpayer in the present case, Interstate Transit Lines, was $183,365.60 of revenue which under the accounting was allocated to California. Included among its disbursements for operating expenses which were actually paid by Interstate was the sum of $211,470.59, which under the same accounting was treated as allocable to Stages. To treat the earnings as those of the agent and the expenses as those of the agent, although both were actually those of the principal, the present taxpayer, in effect defeats the purpose "to tax earnings and profits less expenses and losses"; for the net excess of such allocated expenses over such allocated revenues is eliminated from the calculation of Interstate's net income, and therefore reflects the inclusion of an unreal factor and distorts the present taxpayer's liability, in this case to the "advantage of the entire tax-paying group," and of course to the present taxpayer's disadvantage.

It is after the foregoing language indicating that an unreal factor operating against the taxpayer is no more to be included in the "calculation" than in a case where recognizing the unreality operates to the Government's disadvantage that the dicta appear which were quoted by the Court below. The sentence immediately following this language recites Smith's citation of *Burnet* v. *Commonwealth Improvement Company* "as a precedent for treating the taxpayer and his solely owned corporation as separate entities." Then it is pointed out that in *that case* the taxpayer, for reasons satisfactory to itself, had voluntarily chosen to employ the corporation in its operation; after which the language appears that a taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation must accept its tax disadvantages, while on the other hand the Government may not be required to acquiesce, but may look at "actualities," and upon determination that the form is "unreal or a sham" may "sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." The concluding sentences make it plain that this language was directly related to the discussion of the *Commonwealth Improvement Co.* case and was aimed at "schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation"; for it is "command of income and its benefits which marks the real owner of property."

Although the dicta quoted in the opinion below, when lifted from the context, may appear superficially to sup-

port the lower court's conclusion,[1] the entire opinion tends to sustain the present taxpayer. The result in that case was in accordance with actualities. The principal was not allowed to treat a transaction with his creature, his "corporate self," his mere agent, which he controlled and dominated, as if that agent were a separate, independent entity. In at least two decisions by lower tribunals, *Higgins* v. *Smith* has been regarded as supporting the exact opposite conclusion from that urged on by the Government and upheld by the court below. Thus the Board of Tax Appeals, in *Carling Holding Company* v. *Commissioner*, 41 B. T. A. 493, at page 501, in support of its decision in favor of the taxpayer in a case involving the question whether a corporation was but a mere agent, said:

> "Corporate entity in fact, that is, incorporation in due form of law, has often appeared in cases where the entity was ignored for tax purposes, e. g. *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71; and the very recent decision in *Higgins* v. *Smith*, 308 U. S. 473."

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[1] An interesting article on this subject, entitled "The Function of the Entity in Federal Income Taxation: Recent Developments" by William H. Harrar, a member of the New York Bar employed by the United States Board of Tax Appeals (now the Tax Court), appeared in the January 1941 number of the Minnesota Law Review, 25 Minn. L. Rev. 189. The author points out that "a hasty reading leaves the impression that the Treasury may play fast and loose with legal entities, whenever its adding machines and comptometers tell it that the revenues will thereby wax greater." The article is an interesting discussion of the subject. The writer's analysis is opposed to the one sided doctrine contended for by the government and announced by the Court below.

And the Circuit Court of Appeals for the Tenth Circuit in *Inland Development Company* v. *Commissioner*, 120 Fed. (2d) 986, which was decided in the taxpayer's favor on the ground of the subsidiary's agency, includes *Higgins* v. *Smith* in a collection of cases cited for the proposition that it is "well settled that extraordinary circumstances sometimes exact the disregard of such separateness of entity in the solution of problems relating to taxes." The other cases included which were decisions by this Court were *Southern Pacific Company* v. *Lowe*, *Gulf Oil Corporation* v. *Lewellyn*, *Burnet* v. *Commonwealth Improvement Company*, *Gregory* v. *Helvering*, and *Griffiths* v. *Commissioner*, 308 U. S. 355, 60 S. Ct. 277, 84 L. Ed. 319.

The *Griffiths* case is interesting because it was the alleged conflict between the decisions of the Circuit Courts of Appeals in *Higgins* v. *Smith* and in the *Griffiths* case which were said to have prompted the allowance of certiorari. In the *Griffiths* case Griffiths paid one Lay money for some stock. The investment was unprofitable and the Commissioner allowed a large deductible loss for 1931 from the sale of the stock by Griffiths to a family corporation. Thereafter Griffiths learned that Lay had defrauded him; and as a result of negotiations between the parties, a settlement was arranged under which Lay was to buy the stock back at what Griffiths paid for it; but a corporate device was set up whereby the money, although actually paid to Griffiths' corporation, was to be in turn paid by it to Griffiths in annual installments over forty years. The Commissioner ruled that Griffiths, having been allowed a deduction for loss in 1931 and having recouped his loss through the settlement, was subject to tax in 1933 on the settlement. This court, in an opinion by Mr. Justice Frankfurter, upheld that view, disregarding "the technically elegant arrangement"

which had been devised by a "lawyer's ingenuity." As the opinion says, there was but a simple sale and passage of money, which "was the crux of the business to Griffiths," and which was said to be the "crux of the business" to the Court.

The language in the concluding paragraph in the *Griffiths* case supports the present taxpayer's position. There it is said:

> "We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxes —the actual benefit for which the tax is paid.' *Corliss* v. *Bowers*, 281 U. S. 376, 378. And it makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency."

Corliss v. *Bowers*, 281 U. S. 376, 50 S. Ct. 336, 74 L. Ed. 916, upheld the constitutionality of the provision in the 1924 Revenue Act under which income of a revocable trust was taxable to the grantor. After the sentence quoted by Mr. Justice Frankfurter in the foregoing excerpt from the *Griffiths* case, the opinion in *Corliss* v. *Bowers*, written by Mr. Justice Holmes, points out that a direction to another to pay over income as received to someone else until further orders would of course subject the first individual to taxation upon the amounts so paid. By way of analogy to the present situation, it may be added that if Interstate employed an individual, or an outside corporation, to conduct the California operations, under a similar arrangement as that here involved, no one would doubt that the revenue belonged to Interstate and that the expenses were Interstate's expenses. In the present case the revenues of Stages are, to use

Mr. Justice Holmes' phrase, subject to Interstate's "unfettered command," although in order to receive the revenues Interstate was compelled to bear the burden of the expenses. Mr. Justice Holmes having written the opinion in the *Gulf Oil Corporation* case and concurred in the *Southern Pacific Company* case, it is hardly likely that he would have failed to apply the views expressed by him in *Corliss* v. *Bowers* to a converse situation like that here presented.

In the light of the foregoing analysis, it is evident that the Fourth Circuit Court of Appeals was correct in concluding, in *United States* v. *Brager Building and Land Corporation*, 124 Fed. (2d) 349, that the "body of law" represented by cases such as *Southern Pacific* v. *Lowe* has not "for practical purposes ceased to exist." Yet the court below in very brief language disposes of this legal question by the blanket statement that the corporate entity of the subsidiary cannot be "disregarded" nor the "'tax disadvantage' resulting from its organization avoided," for which *Higgins* v. *Smith* is cited. The *Southern Pacific Company* and *Gulf Oil Corporation* cases are said to have been relied on by the taxpayer, along with the *Brager* and *Inland Development Company* cases, and also *North Jersey Title Ins. Co.* v. *Commissioner*, 84 Fed. (2d) 898. These authorities are disposed of in the single sentence which declares that "they present peculiar situations and were determined upon consideration of them." The opinion fails, however, to point out in what respects these cases are distinguishable; but they are declared to be "not controlling here," for which proposition the *Commonwealth Improvement Company* case and *American Package Corporation* v. *Commissioner*, 125 Fed. (2d) 413, are cited, notwithstanding the fact that the discussion of the problem by the Fourth Circuit Court of Appeals in the opinion in

the latter case supports the present taxpayer's contention. The fact is that the "peculiar circumstances" of the *Southern Pacific* case are to an unusual degree paralleled in the present case. Accordingly that and the other similar cases relied on should have been followed by the Court below. These cases strengthen and indeed compel the conclusion that Stages was but the agent of Interstate, its *alter ego.* In addition, the pleadings admit and the Court below even assumed such agency with respect to the interstate operation, which represented nearly ninety-five per cent of the business. The legal consequences of the agency relationship should, especially in view of these authorities, have been recognized and given effect by the tribunals below, the expenses declared to be Interstate's, and therefore the deficit held to be an "ordinary and necessary expense" of Interstate.

III.

The Limited California Intrastate Operation Did Not Make Payment of Stages' Deficit Any the Less an Ordinary and Necessary Expense of Interstate, Nor Change Stages' Character as Interstate's Agent, Especially as in 1936 a Local Law Provided That a Corporation in California Engaged in Interstate Commerce Might Conduct Intrastate Commerce of Like Character.

Thus far, except for some passing and incidental references, little has been said herein concerning the controlling effect given by both opinions below to the California intrastate operation. The discussion in both opinions makes it necessary to go somewhat into this subject to the end that the questions of law presented by this record be not obscured or confused by this circumstance that a small part of the business conducted in California was intrastate, and that it was to obtain this

augmentation of business that, because of a local regulatory law, Stages was organized. The volume of this intrastate business was but a little over five per cent of the total allocated to California. As to the remaining business, almost ninety-five per cent, the record leaves no doubt that Stages was but an agent, a fact admitted in the pleadings (13) and assumed by the Court below (75). The Board's opinion ignores the agency relationship altogether, but inferentially recognizes its existence as to the intrastate business when it says (18), erroneously, that "whether any or all of the operating deficit of Stages for the taxable year was attributable to the intra-California business of that company is not disclosed," and refers (18, 19), also erroneously, to what it says is "the absence of evidence as to the ordinary and necessary expense of furnishing interstate transportation to and from California." This language seems to imply that the agency rule would apply to the interstate but not to the intrastate operation. This language is not entitled to the weight usually given to a conclusion of the *nisi prius* tribunal on a factual question; for its assertion as to lack of evidence concerning the expense of interstate operation is not only directly opposed to the uncontradicted evidence that no part of the expense was attributable to the intrastate business (34) except for the insignificant cost of extra accounting (42), but is in conflict with the Board's own findings (15, 16) that no additional expense was incurred except such accounting cost.

The Circuit Court of Appeals, although accepting the fact that the additional expense was insignificant and so not falling into this error of the Board, and although recognizing or at least "assuming" Stages' agency, said that the deficit of 1936 was, because of the apportionment

of revenues on a mileage basis, "consequently an incident attributable wholly to the business of the subsidiary," a conclusion impossible to reconcile with Stages' agency as to nearly ninety-five per cent of the entire business.

Both tribunals, therefore, although not in harmony as to their reasons, gave controlling effect to the approximate five per cent of the business, and both bottomed their conclusions on the premise that this part of the business was business which "could not have been the business of petitioner," as the Board expresses it (18), and was business in which Interstate "could not engage," in the language of the Court below (75). In this major premise both tribunals failed to mention a California statute passed in 1935. This Act, a reenactment, with an immaterial amendment, of an Act passed originally in 1915, affirmatively provided that foreign corporations engaging in commerce with foreign nations or commerce among the several states might transact in California "such commerce and intrastate commerce of a like character." (California Public Utilities Act, Deering's 1935 Supplement to California General Laws, Act 6386, page 1622; see Appendix, *infra*, p. 63.) A statute passed in 1927 forbade passenger stage operation without prior approval of the railroad commission (California Public Utilities Act, Section 50¼, Deering's General Laws of California 1931, Act 6386, page 3561, incorrectly given as page 3161 on page 4 of the transcript). It is fairly arguable, in view of the 1915 statute, that the 1927 Act did not by implication repeal the 1915 statute, and therefore that the commission had no power to deny Interstate the right to carry intrastate passengers; but however that may be, the reenactment in 1935 of the 1915 statute made it plain that the 1927 provision respecting the necessity of commission approval as a prerequisite to conducting an

intrastate bus business no longer obtained in 1936 in the case of a corporation like Interstate, and that in that year the California laws affirmatively conferred this right upon such corporations. Although specifically called to the attention of the Court below (79, 80), this point was ignored by that Court.

But even if Interstate could not itself have lawfully carried intrastate bus passengers directly, it still might, and did, validly contract in Nebraska with its subsidiary respecting the entire California operation. There was no charter restriction preventing Interstate from conducting this business, which obviously was within the scope of the activities to conduct which Interstate was organized. It is hard to understand why, even prior to 1935, Interstate, if itself unable, because of local regulations, to conduct the intrastate operation, could not have contracted for the performance of that operation by an entity not so restricted.

As between principal and agent the latter undoubtedly would be the party answerable to the regulatory authorities; but observance of the requirements of the state regulatory statute did not as between these parties convert what was in actuality the principal's business into that of the agent. If there had been a profit, the agent would under the agreement have been compelled to account for it, not by way of dividends but by a direct payment or credit of the amount of such profit. This was in fact done, under the agreement, in prior years in which there were profits (43, 44; Exhibit 3, *ibid*, 61; Exhibit 4, *ibid*, 62), a fact which, singularly enough, is referred to by the Court below (78) as resulting in Stages' having no surplus (which is of course true), and therefore *ipso facto* requiring the conclusion that payment by Interstate of the 1926 operating deficit, which otherwise would

have impaired the subsidiary's capital, was a contribution to that capital. The fact is that Interstate was, as between itself and its subsidiary, lawfully entitled to the excess of revenues over expenses, and also required to bear any excess of expenses over revenues. This was a matter having nothing to do with local regulatory provisions; but it does establish that payment of these expenses constituted an "ordinary and necessary expense" of Interstate.

If, however, the thesis is accepted that when in 1932 Stages acquired the California franchises Interstate was incapacitated itself to conduct the intrastate business and therefore incapable of making a contract as part of its own business operations with a qualified California resident to conduct that business in the latter's name but for Interstate's benefit and as a part of Interstate's business, the fact remains that this branch of the enterprise accounted for only a little over five per cent of the total revenue volume and was responsible for none of the expenses. The intrastate business depended on the prior existence of the interstate operation, not the latter on the former. The interstate operation was already in the field when the intrastate operation commenced; and the absorption agreement emphasizes the dependence of the intrastate business upon the interstate operation. There was no attempt to develop the California intrastate operation as an independent self-sustaining business; but, on the contrary, the California business was to be entirely subservient to the interstate operation, which was taxpayer's main activity. Such intrastate business as might incidentally be secured was a welcome addition to the business as a whole; but there was no effort to engage independently in California intrastate business except as such business might be incidental to the main transportation business. The local business was an appendage to

the interstate business. The collection, nominally for Stages' account, of some $10,000 of intrastate fares, which operated to reduce by that amount what would otherwise have been an Interstate deductible expense, should not, standing alone, preclude the deduction. Indeed that part of the opinion below which declares that the amount to be paid "is not made dependent upon any corresponding unit of benefit to the petitioner or sacrifice of the subsidiary," thus ignoring the express recital in the absorption contract that the operation provided for was solely for the benefit of Interstate and therefore might not be so "remunerative" to Stages as operation "solely for its own corporate benefit" (57), appears not to be influenced by this incidental intrastate traffic, the expense of which is treated as "insignificant" (75). The emphasis in the Board's opinion upon the intrastate operation, and the reference, with somewhat less emphasis, in the opinion of the Court below to the intrastate business as being business in which taxpayer "could not engage" (75), and as being business which taxpayer "had no authority to do" (76), magnify the intrastate operation out of all proportion to its importance.[1] The deficit which was part of the economic cost of the enterprise in which Interstate was engaged, namely, bus transportation, was both "ordinary" and "necessary" and should have been allowed as a deduction.

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[1] If, notwithstanding what is said in the main text, this Court should be of the opinion that there should be some allocation of the expenses to the intrastate portion of the operation, and a more accurate statement of the revenues than the estimate of the Witness Haugh that such revenues were "about $10,000," and if the legal questions now under review, or either of them, are resolved in favor of the petitioner, then it is submitted that there should in the interest of justice be a remand, to enable the petitioner to supply the exact figures.

CONCLUSION.

For the foregoing reasons it is submitted that the Court below erred in deciding that the deficit resulting from the operating expenses allocated to Stages was not an "ordinary and necessary" expense of the petitioner, and that that Court also erred in deciding that the petitioner was precluded from asserting the agency of its subsidiary, Stages, in the conduct of the California operation, and accordingly, that that Court's decision upholding the decision of the Board of Tax Appeals was erroneous and should be reversed, or, if not that, then that that decision should be reversed and the cause remanded for further proceedings.

Respectfully submitted,

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APPENDIX.

Section 23 (a) of the Revenue Act of 1936, 48 St. L. 1658, provides:

> "In computing net income there shall be allowed as deductions:
>
> (a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *"

Section 26 of the California Public Utilities Act (Deering's 1935 Supplement to California General Laws, Act 6386, page 1622), in effect throughout 1936, contains the following proviso:

> "provided, that foreign corporations engaging in commerce with foreign nations or commerce among the several States of this Union may transact within this State such commerce and intrastate commerce of a like character; and, provided, further, that any foreign corporation, which may comply with the laws of this State respecting foreign corporations, and which owns at least ninety per cent of the outstanding capital stock of any other foreign corporation transacting a public utility business in this State, may succeed to the public utility business, franchises and rights of such latter corporation and thereafter continue and carry on such public utility business."

The first four lines of the foregoing (to the semicolon) have been in effect since 1915 (Session Laws, 1915, p. 130). The balance of the above language was added by the 1935 amendment (Session Laws, 1935, p. 1564).

Section 50¼ of the California Public Utilities Act (Deering's General Laws of California, 1931, Act 6386, page 3561, incorrectly given as page 3161 on page 4 of Transcript), adopted in 1927 (Session Laws, 1927, p. 74;

amended in 1931 in a manner not here material, Session Laws, 1931, p. 2598), the statute pleaded, provided in part:

> "No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this state without first having obtained from the railroad commission a certificate declaring that public convenience and necessity require such operation."